# Have We Finally Reached Our Limits? CFTC Proposes New Position Limits Rules in Effort to End Decade-Long Saga

## Introduction

On January 30, 2020, the Commodity Futures Trading Commission (CFTC) approved for publication in the *Federal Register* proposed federal rules (the "Current Proposal") regarding position limits for derivatives contracts on certain commodities.[1] Position limits are authorized by the Commodity Exchange Act (CEA),[2] as amended by Title VII of the Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).[3] The Current Proposal is the latest in a line of numerous attempts by the CFTC to establish such position limits, including a prior set of final rules approved in 2011 but later vacated by the US District Court for the District of Columbia.[4] Public comments on the Current Proposal are due by April 29, 2020. If adopted, market participants would be required to comply with the new position limit regime by one year after publication of the final rule in the *Federal Register*.

In issuing the Current Proposal, the CFTC has indicated that it aims to: (1) recognize, and accordingly tailor position limits to address differences in various commodities and commodity derivatives contracts; (2) focus on derivatives contracts "that are critical to price discovery and distribution of the underlying commodity" to help avoid excessive speculation in contracts having "a particularly acute impact on

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[1] The Current Proposal was approved in a 3-2 vote, with dissents from Commissioners Behnam and Berkovitz. For a PDF copy of the Current Proposal, see Press Release No. 8112-20, Commodity Futures Trading Commission, CFTC Approves Two Proposed Rules at January 30 Open Meeting: Position Limits Proposal Advances After Long Delay (Jan. 30, 2020), https://www.cftc.gov/PressRoom/PressReleases/8112-20.

[2] *See* 7 U.S.C. § 1 *et seq*.

[3] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010), https://www.govinfo.gov/content/pkg/PLAW-111publ203/pdf/PLAW-111publ203.pdf.

[4] In the text of its rule proposal, the CFTC indicated the Current Proposal was the fifth in a line of proposals focused on position limits since the enactment of the Dodd-Frank Act. According to this view, relevant prior proposals include: the rules proposed and finalized in 2011 (Position Limits for Derivatives, 76 Fed. Reg. 4752 (Jan. 26, 2011) (the "2011 Rules")) (which were later vacated by *Int'l Swaps & Derivatives Ass'n v. CFTC*, 887 F. Supp. 2d 259 (D.D.C. 2012)); newly proposed rules in 2013 (Position Limits for Derivatives, 78 Fed. Reg. 75680 (Dec. 12, 2013) (the "2013 Proposed Rules")); supplemental guidance in 2016 (Position Limits for Derivatives: Certain Exemptions and Guidance, 81 Fed. Reg. 38458 (June 13, 2016)); and re-proposed rules in 2016 (Position Limits for Derivatives, 81 Fed. Reg. 96704 (Dec. 30, 2016) (the "2016 Proposed Rules")). *See* Current Proposal at 5-6. However, if one counts *all* relevant rulemaking proposals, the Current Proposal would be the seventh in line because that list would include the two proposals addressing aggregation of positions for purposes of compliance with position limits— a 2013 initial proposal (77 Fed. Reg. 68946 (Nov. 15, 2013)) and the supplemental (and subsequently finalized) proposed rules from 2015 (80 Fed. Reg. 58365 (Sept. 29, 2015)). If one considers only proposals that embody revised numeric position limits, the current proposal is the fourth proposal, following the 2011 Rules, the 2013 Proposed Rules, and the 2016 Proposed Rules. No matter how viewed, however, there have been many proposals related to position limits since the passage of Dodd-Frank Act in 2010.

interstate commerce" for such commodity; and (3) leverage expertise and processes at designated contract markets (DCMs) to "reduce duplication and inefficiency."[5]

Summarized below are key components of the Current Proposal, organized into five general categories:

1. new concepts and definitions impacting position limits more generally;
2. position limits themselves;
3. bona fide hedging and other exemptions from federal position limits;
4. changes to cash-market position reporting; and
5. legal matters (*i.e.*, the "necessity" finding).

Note that the discussion herein is intended as an overview of certain aspects of the Current Proposal and is not intended to be a comprehensive analysis of every aspect of the Current Proposal.

## Current Proposal

### 1. New Concepts and Definitions Impacting Position Limits More Generally

Today, futures contracts on only nine commodities are subject to federal position limits. Separate limits are set for the spot month and non-spot months, as well as for all months combined. These legacy futures contracts all reference agricultural products.[6] The Current Proposal would expand this core futures list to cover an additional 16 contracts, including seven new agricultural contracts, four energy contracts and five metals contracts, for a total of 25 covered contracts.[7]

Under the Current Proposal, position limits would also apply to any contract that is directly or indirectly linked to, or that has a pricing relationship with, a core referenced futures contract, including cash-settled futures contracts and "economically equivalent" swaps. These contracts, along with the core legacy contracts, are broadly defined in the Current Proposal as "referenced contracts."[8] Four types of contracts are specifically excluded from the definition of referenced contract: (1) location basis contracts; (2) commodity index contracts; (3) swap guarantees; and (4) trade options.[9] Should the Current Proposal be

[5] Current Proposal at 7.

[6] These legacy commodity contracts are CBOT Corn (C), CBOT Oats (O), CBOT Soybeans (S), CBOT Wheat (W), CBOT Soybean Oil (SO), CBOT Soybean Meal (SM), MGEX Hard Red Spring Wheat (MWE), ICE Cotton No. 2 (CT), and CBOT KC Hard Red Winter Wheat (KW). *See* 17 C.F.R. § 150.2; Current Proposal at 11.

[7] The non-legacy contracts included in the Current Proposal are CBOT Rough Rice (RR), ICE Cocoa (CC), ICE Coffee C (KC), ICE FCOJ-A (OJ), ICE U.S. Sugar No. 11 (SB), ICE U.S. Sugar No. 16 (SF), CME Live Cattle (LC), COMEX Gold (GC), COMEX Silver (SI), COMEX Copper (HG), NYMEX Platinum (PL), NYMEX Palladium (PA), NYMEX Henry Hub Natural Gas (NG), NYMEX Light Sweet Crude Oil (CL), NYMEX New York Harbor ULSD Heating Oil (HO), and NYMEX New York Harbor RBOB Gasoline (RB). *See* Current Proposal at 11.

[8] *See id*. at 10.

[9] *See id*. at 91.

finalized, the CFTC anticipates maintaining an up-to-date, non-exhaustive list of referenced contracts on its website; the CFTC previously published "workbooks" on this subject alongside prior rule releases and has indicated it will do so again in support of the Current Proposal.[10]

As noted above, economically equivalent swaps are considered referenced contracts and are thus subject to the Current Proposal's position limits regime. Economically equivalent swaps are swaps that have identical "material" contractual specifications, terms and conditions with a referenced contract.[11] As such, any differences with respect to terms that are not deemed to be material would thus be disregarded in determining whether a particular swap meets this definition.[12] The Current Proposal provides that this determination of materiality is at the discretion of market participants, as long as they exercise "reasonable, good faith effort" in making any such determination.[13]

Unsurprisingly, the Current Proposal also contains a generally applicable anti-evasion provision. According to the Current Proposal, the purpose of this provision is to prevent "willful evasion of federal position limits."[14]

### 2. Position Limits Themselves

Under the Current Proposal, the nine legacy referenced contracts would continue to be subject to federal limits in both the spot and non-spot months, as well as combined for all months. However, these limits would increase substantially for most contracts.[15] Non-spot limits would be set at 10 percent of open interest for the first 50,000 contracts and then two and one-half percent open interest thereafter.[16] The Current Proposal only contains spot month limits for the other 16 referenced contracts, though DCMs will be required to establish limits or accountability levels outside the spot month for these contracts.[17] A

[10] *See id*. at 95.

[11] Examples of such material provisions include the underlying commodity, maturity or termination dates, settlement type, and delivery specifications (for physically-settled contracts). *See id*. at 77.

[12] Examples of disregarded provisions include lot size or notional amount, delivery dates diverging by less than one calendar day (two calendar days for natural gas), post-trade risk management arrangements (such as those relating to clearing or margin), business day or holiday conventions, and choice of law. *See id*. at 78, 80.

[13] *Id*. at 79-80.

[14] The Current Proposal includes three different examples of trading strategies or structures that could be violations of the anti-evasion provision, one of which explicitly provides that a swap contract designed to evade position limits would be deemed "economically equivalent" and thus a referenced contract. *See id*. at 142-43.

[15] With respect to spot month limits, the only legacy contract for which the limit remains unchanged is CBOT Oats (O). *See id*. at 107-08. With respect to non-spot month and all months' limits, the limit for CBOT Oats (O) is again unchanged, as are the limits for KC Hard Red Winter Wheat (KCW) and MGEX Hard Red Spring Wheat (MWE). *See id*. at 124.

[16] *See id*. at 125.

[17] *See id*. at 122.

higher “conditional” position limit for spot-month cash-settled NYMEX Henry Hub Natural Gas (NG) contracts is available to market participants who do not hold or control any spot month physically-settled NYMEX NG positions.[18]

All proposed spot month limits have been set at levels that are equal to or less than 25 percent of the total deliverable supply for such commodity, which supply figure has been estimated from data provided by the relevant DCMs.[19] All spot month limits are separately calculated with respect to cash-settled and physically-settled positions; as such, in the spot month, a person can net positions within but not across each settlement category.[20] There is no such distinction for non-spot month limits, so cash-settled and physically-settled positions can be netted against each other. Relevant futures equivalent positions would be calculated by combining a person’s futures, options on futures and economically equivalent swaps positions.

With respect to contracts that are subject to federal position limits, DCMs may not establish spot month exchange-set limits that are higher than applicable federal limits; with respect to any commodity contract that is not otherwise subject to federal position limits, DCMs are authorized to establish spot and/or non-spot limits or accountability levels.[21]

### 3. Bona Fide Hedging and Other Exemptions from Federal Position Limits

The Current Proposal contains a revised definition of bona fide hedging. Substantively, the most important changes include: (1) the removal of the concept of “risk management” hedging as covered by the definition, since the CFTC is interpreting that bona fide hedges must always be in connection with the production, sale or use of a physical, cash-market commodity;[22] (2) the explicit acknowledgment that term “risks” as used in the definition only applies to pricing risk;[23] (3) the elimination of the incidental trading test, the orderly trading requirement and the so-called “five-day” rule (which in its current form prevents hedgers from electing an exemption for certain enumerated edges in physical delivery contracts during the last five days of trading in the spot month—per the Current Proposal, DCMs could choose if and in which instances to keep this rule in place);[24] and (4) the inclusion of pass-through swaps as bona fide

[18] *See id*. at 163.

[19] *See id*. at 111.

[20] *See id*. at 145-46.

[21] *See id*. at 177, 186.

[22] *See id*. at 36-37.

[23] *See id*. at 39.

[24] Per the Current Proposal, DCMs could choose if and in which instances to keep the “five days” rule in place. *See id*. at 41-42, 61-62.

hedges, provided that the non-hedging party (a) can demonstrate that the swap is a bona fide pass-through and (b) enters into the offset swap to reduce price risk attendant to the pass-through swap.[25]

The Current Proposal also includes an expanded list of enumerated hedges. These enumerated hedges are automatically considered to be bona fide and are self-effectuating at the federal level, meaning that positions that meet one of the enumerated hedges would not count toward federal position limits with respect to that contract.[26] There are 11 enumerated hedges in the Current Proposal, five of which are new, while most of the other six are subject to some limited modifications compared to their current forms. The five new enumerated hedges are short hedges of anticipated mineral royalties, hedges of anticipated services, hedges by agents, offsets of commodity trade options, and hedges of anticipated merchandising.[27] The six existing enumerated hedges that would remain valid as bona fide hedges would be somewhat revised from their existing definitions—these enumerated hedges include hedges of unsold production, hedges of offsetting unfixed-price cash commodity sales and purchases, cross-commodity hedges, hedges of inventory and cash commodity fixed-price purchase contracts, hedges of cash commodity fixed-price sales contracts, and hedges of unfilled anticipated requirements.[28]

Beyond enumerated hedges, the Current Proposal establishes a procedure by which market participants can request exemptive recognition for other bona fide hedges. Such exemptive relief can be requested either directly from the CFTC or from a DCM. In the case of exemptions requested from DCMs, a streamlined process applies—upon approval by the DCM of an application for hedging treatment, the trader can immediately benefit from such hedge treatment at the relevant exchange, and the hedge remains a valid exemption unless the CFTC Commissioners vote to overturn the DCM's approval, which the Commissioners must do within 10 days of such approval (two days under expedited procedures, which are available for exigent circumstances).[29] After this period, the non-enumerated hedge exemptions are available at the federal level, absent CFTC reversal.

In evaluating their positions against federal position limits, the Current Proposal provides that market participants can measure their risk on either a gross or net basis. However, they must do so consistently and cannot use this flexibility as a means to evade federal position limits.[30]

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[25] *See id*. at 68.

[26] Exchange-set limits must be considered separately, and thus exemptions from those limits would need to be requested from the exchange. *See id*. at 153.

[27] For further details on each of these hedges, *see id*. at 479-82 (Appendix A).

[28] *See id*.

[29] *See id*. at 204-05.

[30] *See id*. at 65.

#### 4. Changes to Cash-Market Position Reporting

Existing regulations require market participants that hold bona fide hedging positions in excess of the position limits for the legacy contracts to justify those overages by filing either Form 204 or Form 304 (the latter being used for cotton positions). The Current Proposal would eliminate Form 204 and parts 1 and 2 of Form 304, which pertains to fixed-price positions in cotton.[31] Instead, the CFTC proposes that it would receive monthly data on hedging recognitions and exemptions via reporting by DCMs.[32]

#### 5. Legal Matters (*i.e*., the "Necessity" Finding)

As discussed at length in the Current Proposal, the CFTC has preliminarily interpreted Sections 4a(a)(1) and 4a(a)(2) of the CEA as requiring that the CFTC establish position limits as it "finds are necessary to diminish, eliminate, or prevent" certain enumerated burdens on interstate commerce.[33] Thus, in issuing the Current Proposal, the CFTC asserts that it has made this required finding to support the establishment of speculative position limits with respect to the 25 core referenced contracts (and the referenced contracts therewith).[34]

Each CFTC Commissioner, including the two dissenters, issued a statement in connection with the Current Proposal. These statements demonstrate the differing views within the Commission over how to approach the required necessity determination, which ultimately derives from somewhat ambiguous wording in the CEA[35] and from unclear language in the court decision that vacated the CFTC's first effort to revise its position limits regime in 2011.[36] It is apparent that reasonable people can fairly disagree on the precise meaning or legal standard underlying this "necessity" determination.

## Conclusion

As CFTC Chairman Tarbert acknowledged in his statement supporting the Current Proposal, the CFTC has "grappled with position limits for a decade," noting that the Current Proposal is "the culmination of 10 years of effort across four Chairmen's tenures."[37] Chairman Tarbert, in particular, has shown a distinct interest in closing the book on the position-limits saga—in a recent *Bloomberg TV* interview, he indicated

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[31] *See id*. at 221.

[32] *See id*. at 224. It is not clear from the Current Proposal what equivalent information DCMs receive on an ongoing basis. No additional information collection from market participants would be required by DCMs under the Current Proposal.

[33] *Id*. at 232.

[34] *Id*. at 253.

[35] *See* 7 U.S.C. § 6a(a).

[36] *See Int'l Swaps & Derivatives Ass'n v. CFTC*, 887 F. Supp. 2d 259 (D.D.C. 2012).

[37] Heath P. Tarbert, Chairman, CFTC, Statement in Support of Proposed Rule on Speculative Position Limits (Jan. 30, 2020), https://www.cftc.gov/PressRoom/SpeechesTestimony/tarbertstatement013020.

that he plans to finalize the proposed rules later this year.[38] It remains to be seen whether this goal can be accomplished in an election year, but it seems likely that there will be more developments on this issue in the near term.

[38] Ben Bain, *U.S. to Propose Oil Speculation Rule This Month: CFTC's Tarbert*, Bloomberg Law, Jan. 13, 2020, https://news.bloomberglaw.com/securities-law/u-s-to-propose-oil-speculation-rule-this-month-cftcs-tarbert.

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